

Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply to:

Date:

MAY 13 1986

EIN: [REDACTED]
District: [REDACTED]

Dear Applicant:

We have considered your application for recognition of exemption from federal income tax as an organization described in section 501(c)(3) of the Internal Revenue Code. For the reasons stated below, we have concluded that you do not qualify for tax exemption under this section. Your protest rights are also stated below.

You were incorporated on [REDACTED], pursuant to the nonprofit statute of the State of [REDACTED]. Article Third of the incorporating instrument sets forth your purposes as follows:

"[REDACTED] was formed, to do whatever it legally can, to help our public drinking, and bathing water, be cleaner, or properly cleaned. Public awareness, interest, fundraising, education, working for public support, government, and private enterprise action, are all covered, by some aspect, of [REDACTED]. [REDACTED] arouses interest, in healthy, safe water use, at home and away from home, and the need for money, to improve water cleaning equipment."

You operate out of the home of your founder and President, [REDACTED]. [REDACTED] has performed by himself all of your operations to date. He has presented an "original proposal" to various governmental authorities concerning healthy water use, fund-raising, and the positive role which you may play in improving the nation's water quality. Funds raised by you will be used to help water cleaning companies improve their equipment and materials, improve equipment and materials in homes and other buildings, and to provide employment, nationally, on jobs related to improving the nation's water system. Further, water related manufacturing companies will be aided.

You will turn over money collected, minus payment for employees and office maintenance charges, to the proper branch of government for water cleaning purposes. In addition, funds will be turned over to "specific areas of the general community", to purchase items necessary to have cleaner

[REDACTED]

water in homes, schools, and public places.

In a development letter dated [REDACTED], we inquired as to the criteria for determining the beneficiaries (governmental units, for profit corporations, or private individuals) of funding to improve water quality. We requested that you describe the "procedures for ascertaining needs, making contacts, determining the appropriate remedies, dispensing funds, supervising projects (or checking on progress), and all other factors which relate to the implementation of programs to improve water quality".

You responded, in part, as follows:

"More specific details can be worked out later...Companies that the government uses to clean our public water, and poor people, who can't afford water filters or conditioners, will be helped, as well as with dermatology prescriptions where needed. Records will be kept."

Elsewhere, [REDACTED] informs us that, "Offices in other major metropolitan areas, or under my office, can have an office manager in my place, making \$[REDACTED]/hr. [REDACTED] percent of the money they collect, is to be deposited to my office, [REDACTED] % of which would be my royalty payment, for starting [REDACTED], if that is all right with the government."

You have submitted proposed budgets covering the period [REDACTED] through [REDACTED]. Funds will be expended for office lease or rental, burglar alarm system, office supplies, insurance, and attorney's fees. "Employee Proposals 1-3" include hourly wages for various classifications of employees. Under all three proposals, [REDACTED] will be compensated at a rate of \$[REDACTED] per hour.

The last paragraph of a flyer dated [REDACTED], includes the sentence, "[REDACTED] is a money-making project for [REDACTED]." [REDACTED] later commented on this sentence as follows: "I can and must be paid for office work, record keeping, monitoring, fund-raising, mailings, and administration of [REDACTED]." He further stated that payment to him may have to be delayed until the organization is more solvent.

In a letter dated [REDACTED], you state that you owe [REDACTED] \$[REDACTED] for work performed in the period [REDACTED] to [REDACTED].

A letter dated [REDACTED], signed by [REDACTED], underneath which is stated "Founder and President of [REDACTED]", begins "Dear Company" and contains the following statement in paragraph two:

"... I am interested in endorsing company water use products, and because I would like to know if you are interested in purchasing, and using this water

sterilization idea of mine."

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated "exclusively" for religious, charitable, educational, or other specified exempt purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations provides that in order to qualify for exemption under Code section 501(c)(3), an organization must be both organized and operated exclusively for one or more exempt purposes. Failure to meet either the organizational or operational test will disqualify an organization from exemption under section 501(c)(3). Furthermore, an applicant organization has the burden of proving that it clearly meets all the requirements of the particular Code section under which it has applied. See Kenner v. Commissioner (63-2 U.S.T.C. para. 9519) 318 F. 2d 632 (7th Cir. 1963) and Cleveland Chiropractic College v. Commissioner, (63-1 U.S.T.C. para. 9200) 312 F. 2d 203, 206 (8th Cir., 1963).

A fundamental requirement of the organizational test is set forth in section 1.501(c)(3)-1(b)(4) of the regulations. It requires that, upon dissolution, the assets of the organization would, by reason of the organization's governing instrument or operation of law, be distributed to accomplish one or more exempt purposes (within the scope of Code section 501(c)(3)) or be distributed to a governmental unit (Federal, State, or local) for a public purpose.

Concerning the operational test under Code section 501(c)(3), section 1.501(c)(3)-1(b)(1)(v) of the regulations states that an organization must, in order to establish its exemption, submit a detailed statement of its proposed activities with and as a part of its application for exemption. Section 1.501(a)-1(b)(2) provides that the Service "may require any additional information deemed necessary for a proper determination of whether a particular organization is exempt under section 501(a)...."

Rev. Proc. 80-25, 1980-1 C.B. 667 sets forth revised procedures with regard to applications for recognition of exemption from federal income tax under sections 501 and 521 of the Internal Revenue Code. Section 5.02 states in pertinent part that:

"Exempt status will be recognized in advance of operations if proposed operations can be described in sufficient detail to permit a conclusion that the organizations will clearly meet the particular requirements of the section under which exemption is claimed. ...The organization must fully describe the activities in which it expects to engage, including the standards, criteria, procedures, or other means adopted or planned for carrying out the activities; the anticipated sources of receipts; and the nature of contemplated expenditures. Where the

organization cannot demonstrate to the satisfaction of the Service that its proposed activities will be exempt, a record of actual operations may be required before a ruling or determination letter will be issued. In those cases ... a refusal to issue a ruling or determination letter will be considered an adverse determination from which administrative appeal rights will be afforded." (emphasis supplied).

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more exempt purposes under section 501(c)(3). Under Subparagraph (2), an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals. Furthermore, courts have interpreted the statute's prohibition against inurement of net earnings to be absolute in nature, i.e., the amount or extent of benefit is not a determining factor. See The Founding Church of Scientology, (69-2 USTC para 9538), 412 F. 2d 1197 (Ct. Cls.) and Spokane Motorcycle Club v. United States, (63-2 USTC para. 9681), 222 F. Supp. 151 (E.D. Wash. 1963).

In the case of People of God Community v. Commissioner, 75 T.C. 127 (1980), the Tax Court concluded that part of the organization's net earnings inured to the benefit of private shareholders or individuals and accordingly held that the organization is not tax exempt under section 501(c)(3). The facts showed that the organization's founder and one of its three ministers received compensation based on a percentage of the gross tithes and offerings received by the "church". Generally, the percentage is based on what this individual received in the prior year, adjusted upward to reflect his increased personal expenses and downward to the extent that larger gross receipts permit an increase in the compensation of the organization's other ministers, who also receive a (smaller) percentage of gross tithes. No upper limit is set for the total amount which the founder could receive under the formula.

The Tax Court concluded that private inurement resulted from the above arrangement because of the complete control of the organization vested in the three ministers. However, the Court made clear that not all percentage compensation arrangements are objectionable, as follows:

"We do not, however, mean to imply that all contingent compensation arrangements made by charitable organizations will preclude tax exempt status. Such arrangements are a part of business life and must occasionally be paid by a charity to salesmen, publishers, support groups, and even fund raisers. See Broadway Theatre League of Lynchburg, Va. v. United States, 293 F. Supp. 346 (W.D. Va. 1968). Science and Research Foundation, Inc. v. United States, 181 F. Supp. 526 (S.D. Ill. 1960). What is prohibited is inurement 'to the benefit of any private shareholder or individual.' Section 501(c)(3);

section 1.501(c)(3)-1(c)(2), Income Tax Regs. The term 'private shareholder or individual' refers to persons who have a personal and private interest in the payor organization. Section 1.501(a)-1(c), Income Tax Regs; Gemological Institute of America v. Commissioner, supra (17 T.C. 1604 (1952), affd. per curiam 212 F. 2d 205 (9th Cir 1954)). The term does not refer to unrelated third parties."

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations provides that an organization is not organized or operated exclusively for one or more exempt purposes under section 501(c)(3) unless it serves a public rather than a private interest. Thus, to meet the requirements of this section, it is necessary for an organization to establish it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

With respect to your own application under Code section 501(c)(3), we note that your incorporating instrument does not have a provision which dedicates your remaining assets to exempt purposes (within the meaning of section 501(c)(3)) upon your dissolution. Thus, you do not meet the requirement under section 1.501(c)(3)-1(b)(4) of the regulations. In addition, your governing instrument does not contain any language which limits your activities to those within the scope of section 501(c)(3) or language which prohibits the inurement of your net earnings to the benefit of any private parties.

Concerning the operational test, you have not furnished us with detailed information concerning the methods and procedures which you will utilize to implement your water quality improvement program despite our specific request for such information. This failure or refusal to furnish information which is responsive to our developmental inquiry is ground for concluding that you do not meet the operational test under Code section 501(c)(3). See Rev. Proc. 80-25, Sec. 3.02.

There is another ground for concluding that you do not meet the operational test under section 501(c)(3). The evidence furnished is that, to date, your activities have been conducted by one man, [REDACTED], who is your founder and President. The reality is that [REDACTED] has complete and exclusive control over your policies and day-to-day operations. As such, he is clearly a "private shareholder or individual" within the meaning of section 1.501(a)-1(c) of the regulations. You have stated that [REDACTED] will be compensated at a rate of \$[REDACTED]/hour, despite his lack of any particular expertise or educational background with respect to water quality. Based on this rate of compensation, you have stated that you owe [REDACTED] \$[REDACTED] for work performed in the period [REDACTED] to [REDACTED]. We note that [REDACTED] is the only person in a position to determine the actual hours that he worked on your behalf. We also take note of the statement in the letter of [REDACTED], that "[REDACTED] is a

money-making project for [REDACTED]." Inasmuch as [REDACTED] is in a position to set his own salary, and the rate of compensation appears excessive, we conclude that your net earnings will inure to the benefit of a private shareholder or individual in contravention of the requirement under section 1.501(c)(3)-1(c)(2). Furthermore, the planned arrangement whereby [REDACTED] will receive a [REDACTED]% royalty from funds remitted to you by future branch offices is clearly an objectionable percentage compensation arrangement, given Mr. Karriem's controlling position. As such, it also constitutes inurement of your net earnings within the meaning of section 1.501(c)(3)-1(c)(2). In this regard, see the discussion in People of God Community, cited above.

[REDACTED] has also attempted to capitalize on his position as your founder and President to advance his personal financial interest. We refer specifically to his proposed endorsement of "company water use products" as well as his attempt to sell his own "water sterilization idea" in the letter of [REDACTED]. This exploitation of his connection to you is another clear indication that you are organized and operated to serve a private, rather than a public, interest. In this context, see the requirement under section 1.501(c)(3)-1(d)(1)(ii) of the regulations.

The available evidence indicates that you are neither organized nor operated "exclusively" for exempt purposes under Code section 501(c)(3). Section 1.501(c)(3)-1(a)(1) of the regulations provides that an organization is not exempt under section 501(c)(3) if it fails to meet either the organizational or operational test.

Based on the foregoing, we hold that you are not exempt from federal income tax under section 501(c)(3) of the Code. Therefore, contributions to you are not deductible under section 170 of the Code. You are required to file federal income tax returns on Form 1120.

You have the right to protest this ruling if you believe it is incorrect. To protest, you should submit a statement of your views, with a full explanation of your reasoning. This statement must be submitted within 30 days from today, in duplicate, and must be signed by one of your principal officers. When sending a protest or other correspondence with respect to this case, you will expedite its receipt by placing the following symbols on the envelope: [REDACTED]. These symbols do not refer to your case, but rather to its location.

You also have a right to a conference in this office after your statement is submitted. If you desire a conference, you must request it when you file your protest statement. If you are to be represented by someone who is not one of your principal officers, he must file a proper power of attorney and otherwise qualify under our Conference and Practices Requirements.

If you do not protest this proposed ruling in a timely manner, it will be considered by the Internal Revenue Service as a failure to exhaust available

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administrative remedies. Section 7428(b)(2) of the Internal Revenue Code provides, in part, that, "A declaratory judgment or decree under this section shall not be issued in any proceedings unless the Tax Court, the Claims Court, or the district court of the United States for the District of Columbia determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service."

If we do not hear from you within 30 days, this ruling will become final and copies will be forwarded to the District Director, Cincinnati, Ohio, which is your key district for exempt organization matters. Thereafter, any questions about your federal income tax status should be addressed to your key District Director. The appropriate State officials will be notified of this action in accordance with section 6104(c) of the Code.

Sincerely yours,

(signed) [REDACTED]

[REDACTED]
Chief, Exempt Organizations
Rulings Branch

cc: DD, Cincinnati
Attn: EO Group

[REDACTED]

cc: [REDACTED] State officials